

ELEMENTS OF THE GENERAL FUND FORECAST

ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT

Overview

This document provides for City Council consideration three alternative forecast scenarios for General Fund revenues and expenditures. The “**Base Case**” is considered the most likely projection and that which the Administration recommends be used to formulate the 2007-2008 Proposed Operating Budget. Given the uncertainties inherent in any forecast for a period as long as five years, however, we also provide two alternative case forecasts for the General Fund for the next five years which attempt to model the potential impact of more optimistic and pessimistic views of the future economic environment and the impacts of offering different salary packages.

The Base Case forecast has been built on the assumption that continued modest economic growth will be experienced over the next five years, with some impacts associated with the slowdown in the housing market. As a result, the Base Case projects sustained, but moderate, growth in General Fund revenue collections in the first two years of the forecast with slightly stronger growth in the out years of the forecast as the housing market is expected to show some improvement.

The **Optimistic Case** projects the potential outcome if a more vigorous rate of growth were to develop. In this scenario, the local housing market is stronger as a result of lower than expected interest rates. The Optimistic Case also assumes that costs will be contained by reducing the salary increases by 1% from the growth rate assumed in the Base Case in the last three years of the Forecast. The **Pessimistic Case**, alternatively, attempts to model the potential outcome of rising interest rates, which would impact the local housing market, consumer confidence, overall business growth, and local employment growth. Salary increases are also 1% higher than those in the Base Case in the last three years of the Forecast.

As with all forecasts, this one is based on a series of assumptions regarding the overall economic environment, now and in the future. These assumptions were reached after reviewing the projections included in a number of economic forecasts. The economic conditions and the projected impacts on the City revenues will continue to be closely monitored and any new developments will be factored into the City Manager’s 2007-2008 Proposed Operating Budget, scheduled to be published on May 1, 2007.

The following is a discussion of both the national and local economic outlooks used to develop the revenue estimates for this forecast. The revenue forecast is largely based on the national and State economic forecasts produced by the Anderson School of Management at UCLA, the expectations of local forecaster Stephen Levy, Senior Economist and Director of the Center for the Continuing Study of the California Economy, and the California Fiscal Outlook report issued by the Legislative Analyst’s Office. The City uses an economic forecasting consultant to assist in the development of this forecast, particularly the modeling of the growth in the out years of the forecast.

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National/California Outlook

Based on several economic forecasts, the U.S. economy is expected to continue to grow but at a slower rate in 2007, primarily as a result of the housing market slowdown. For 2007, UCLA predicts that economic growth will be lower than the average of what has occurred for the last several years. The primary reason for the slowing will be the ongoing effect of a declining housing market. The 2006 edition of the California Economic Growth issued by the Center for Continuing Study of the California Economy also echoes this prediction "Economic growth in 2007 should be slower than in 2006. A housing slowdown has begun and should continue into next year. This will restrain job growth and consumer spending."

In addition, recent financial reports by the country's largest corporations are showing a significant slowdown in profit growth. As profits fall, employment declines are not usually far behind. Interest rates are also inching upward as the result of inflation fears and a falling dollar. Rising interest rates have historically made it more difficult for people to buy cars and other big-ticket items as well as held down housing growth.

Despite these problems, unemployment remains relatively low for the nation, State, and region. In addition, high tech, aerospace, defense and agriculture, all important sectors of the economy, continue to experience gains. For 2007, UCLA is forecasting a slowing economy but only down to a 2% Gross Domestic Product (GDP) growth rate.

The intermediate outlook, two to three years out, is more difficult to predict. At the end of this intermediate time horizon, the U.S. will have a new president with new policies for the economy and international relations. The UCLA forecasters assume that the Federal Reserve will be cutting interest rates in 2007 thereby improving the outlook for 2008. GDP in 2008 is forecast by UCLA to grow at over 3%, a very healthy pace. During the early part of this time period, UCLA's inflation rate forecast is below 2%, which is historically quite low. This low inflation reflects falling energy and other commodity prices. After 2008, the growth rate of the GDP begins to moderate.

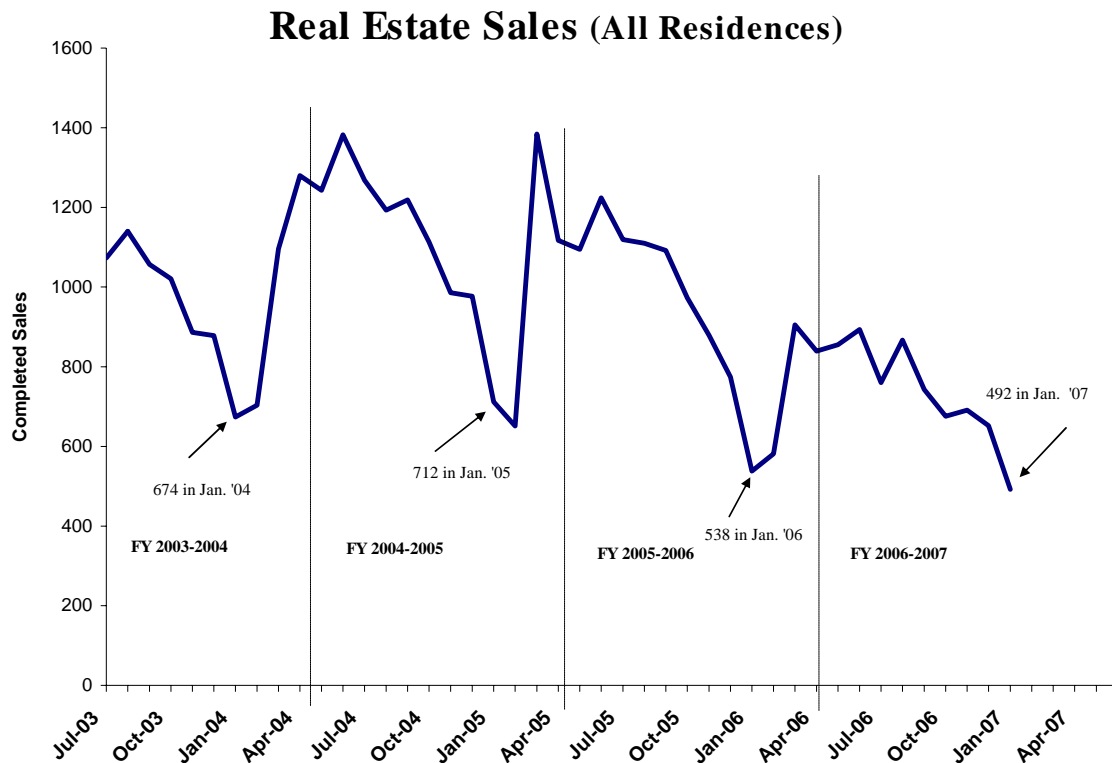
The longer-term outlook, four to five years out, is usually determined by long-term historical trends and ongoing demographic changes. Usually the demographic trends are mostly benign. However, by the very end of the current five-year forecast horizon, very important long-run demographic trends will have started. This upcoming demographic phenomenon is the baby boom retirement. While this mass retirement will not be good for the economy, these changes will not be far enough along to have a great impact on this forecast. Future forecasts, however, will need to take these huge demographic changes into consideration.

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Santa Clara County/City of San José Outlook

Consistent with the national outlook, the slowdown in the housing market is expected to impact this region. For San José, the slowing housing market can directly impact a number of the City's revenue sources, including Property Taxes and Construction and Conveyance Taxes. The slowdown in this area can also indirectly impact Sales Tax collections with the downward spending in construction materials and the reduction of consumer spending as the "wealth effect" associated with housing appreciation diminishes. As shown in the chart below, the number of housing sales in San José has dropped significantly in the last year.

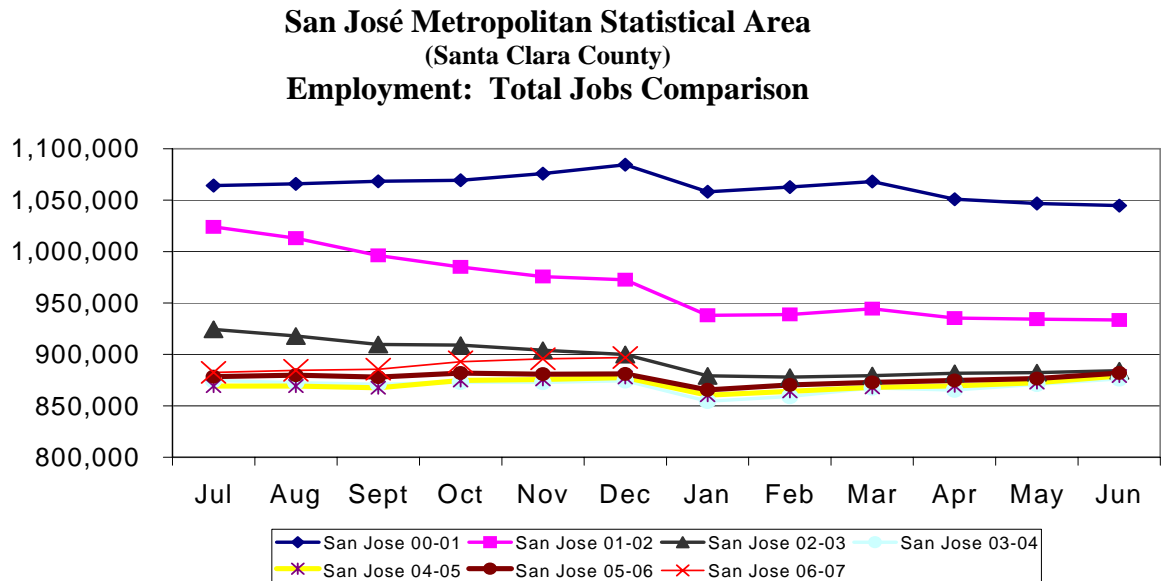


While the housing market continues to present challenges, employment in the area has now stabilized and shown slight gains. As shown in the chart below, the total employment figure of 896,900 jobs in December 2006 was approximately 2% above the 881,100 jobs in December 2005 and the 877,400 jobs in December 2004. Between November and December, employment grew by 1,200 jobs. As reported in the San José Mercury News on January 20, 2007, the growth of 15,800 jobs between December 2005 and December 2006 is the largest year-over-year growth since April 2001. Stephen Levy is also quoted in this San José Mercury News article as stating "It looks like we can finally say the jobs recovery is really here. It's no longer just a possibility. It seems real now."

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ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

Santa Clara County/City of San José Outlook (Cont'd.)



In addition to the modest gains in the number of jobs, the local unemployment rate remains low. The December unemployment rate for the San José area (unadjusted) was 4.2%, down slightly from 4.5% in November 2006 and below the December 2005 level of 4.5%. The December results for the San José area were slightly below the unadjusted figures for the State (4.6%) and the nation (4.3%).

In summary, the forecast for the General Fund assumes that during the forecast period the City will experience moderate levels of revenue growth. As explained elsewhere in this forecast document, however, even these improved revenue growth levels are not sufficient to match the higher expenditure growth levels anticipated during the same period. The result is another General Fund forecast projecting relatively small, but persistent, shortfalls in the General Fund in each year of the forecast period.

Economic Drivers

The 2008-2012 Base Case Forecast was built utilizing the following specific economic assumptions:

- The National Real Gross Domestic Product will grow 3.1% in 2007-2008 and 2008-2009, 3.2% in 2009-2010, 3.4% in 2010-2011, and 2.8% in 2011-2012.
- The prime rate will range from a low of 7.6% in 2007-2008 to a high of 8.2% in 2011-2012.

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ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

Economic Drivers (Cont'd.)

- Mortgage rates will remain at relatively stable levels over the period, ranging from 6.1% in 2007-2008 to 7.5% in 2011-2012.
- The national unemployment rate will remain relatively low at 5.1% in 2007-2008, 5.0% in 2008-2009 and 2009-2010, 4.8% in 2010-2011, and 4.8% in 2011-2012.
- National employment growth will rise 0.98% in 2007-2008, and increase slightly in the out years, averaging 1.2% over the period.
- Historically low national inflation rates will rise only slightly, with growth averaging 2.3% over the forecast period, with a low of 1.8% in 2008-2009 and a high of 3.2% in 2011-2012.
- Local inflation rates will track slightly above the national levels and will average 2.6% over the forecast period, with a low of 1.9% in 2008-2009 and a high of 3.3% in 2011-2012.
- The County unemployment rate will remain below the national level, averaging 4.6% over the forecast period, with a low of 4.5% in 2010-2011 and a high of 4.8% in 2007-2008.
- Total County employment growth rates will average 1.4% over the forecast period, decreasing slightly throughout the years of the forecast, changing from 1.5% in 2007-2008 to 1.3% by 2011-2012.

Optimistic and Pessimistic Scenarios

As discussed above, all forecasts are burdened with a large degree of uncertainty, which increases going further into the future. As a result, in addition to the Base Case, two alternate, but plausible, revenue forecast scenarios are also presented in this document: a “Pessimistic” and an “Optimistic” case. These alternatives were developed to display the range of possible outcomes over the next five years under varying economic conditions. The Base Case is, however, still considered the most likely outcome. The scenarios presented were created using specific sets of differing economic and political assumptions.

Optimistic Case

The Optimistic Case is one in which both the national and the local economies experience a more robust growth rate than envisioned in the base scenario. Specifically, the local housing market is stronger in this scenario as a result of lower than expected interest rates. This housing market strength affects property taxes directly through higher valuations and sales taxes indirectly through higher consumer confidence and borrowing power.

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ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

Optimistic and Pessimistic Scenarios (Cont'd.)

Currently, local employment growth is tracking at a rate higher than anticipated at this time last year. The Base Case assumes that this high rate of growth will subside in the coming years. In the optimistic scenario, local employment is assumed to continue at a higher rate of growth than that forecast in the base case. Also, the stronger U.S. economy under this scenario causes a greater increase in the demand for high-tech equipment. This would result in greater than expected investment by venture capital, more start-ups and consequently more hiring. Under this scenario, the City's two largest revenue generators, sales tax and property tax, would see the largest improvement. By the final year of the forecast, sales taxes are over 4% higher than the base case and property taxes are almost 9% higher.

On the expenditure side, costs are contained by assuming that salary increases would be 1% lower per year starting in the third year of the forecast when compared to the Base Case. This would result in savings of \$6.1 million in 2009-2010. By the end of the five-year period, costs would be \$19.6 million lower than in the Base Case.

Pessimistic Case

In the pessimistic case, interest rates are increasing. This increase may be the result of a number of factors, including the decline in the dollar on the foreign exchange markets or increases in the price of oil. The higher interest rates significantly impact the local housing market. In this scenario, both home prices and resale activity decline sharply, more than envisioned in the base case. Typically, when home prices fall consumer's confidence tends to fall with it as does their ability to borrow in the home equity markets. These events will have a significant impact on both property taxes and sales taxes.

Local employment, one of the most important variables affecting local revenues, also falls in each year of this scenario. If higher interest rates do materialize at the national level, these higher rates will slow overall business in the U.S. and the world as a whole. Lower local employment results from decreased demand for high tech goods at the national level and a lack of any significant innovation from the County's businesses.

On the expenditure side, costs are growing at a faster pace than in the Base Case. This scenario assumes that salary increases would be 1% higher per year starting in the third year of the forecast when compared to the Base Case. This would result in additional costs of \$6.0 million in 2009-2010. By the end of the five-year period, costs would be \$20.0 million higher than in the Base Case.

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ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

Impact of Forecasted Economic Conditions on Revenue Collections

The economic conditions discussed above are the primary drivers for approximately half of the City's General Fund revenues, with the most significant impacts in the Sales Tax and Property Tax categories. The remaining areas, while impacted by overall economic performance, are primarily driven by other factors. For example, the Utility Tax and Franchise Fee categories are more heavily impacted by utility rate changes and energy prices than economic growth. Collections in the Fines, Forfeitures, and Penalties category remain relatively flat under all economic conditions, while collections from local, State, and federal agencies are primarily driven by the grant and reimbursement funding available from these agencies. In the cost-recovery fees and charges programs, revenue collections must be directly linked to costs with the result that the General Fund experiences no net gain or loss in times of an economic expansion or slowdown, respectively. Because these revenue sources do not track directly with the performance of the economy, the growth in these areas, even in times of economic strength, can hold down the City's overall revenue growth. Conversely, in an economic slowdown, these categories can act as a buffer, easing the impact of drops in the economically sensitive categories.

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REVENUE FORECAST

Consistent with past forecast methodologies, the first year of the revenue forecast (2007-2008) was prepared in a manner similar to the preparation of the base budget revenue estimates. Over 500 revenue sources were examined to estimate the outcome in 2006-2007 and, building upon those projections, revenue estimates for 2007-2008 were developed. These revenue estimates will be closely examined and updated again during the development of the 2007-2008 Proposed Operating Budget.

As displayed in the forecast, revenues (exclusive of Beginning Fund Balance) are shown to increase from \$779.7 million in 2007-2008 to \$872.3 million in 2011-2012, for an average growth rate of 2.78% per year. This growth rate is lower than that projected in the last forecast presented in February 2006 (3.19%) primarily due to the presumed sunset of the Emergency Communication System Support Fee in 2009-2010 but also slightly lower growth rates in the economically sensitive categories.

Understanding the basis for the revenue estimates included in this forecast requires discussion of the assumptions used for estimating each of the revenue categories. The following discussion focuses on estimates used for the 2007-2008 General Fund Forecast.

Property Tax

Property Tax receipts of \$187.0 million are projected for 2006-2007, which represents growth of 12.3% over the prior year. This strong growth reflects increases in both the Secured and Unsecured categories, offset by decreases in the SB 813 (property resales) collection areas. In 2007-2008, the overall rate of growth is expected to slow to 6.2% to a total collection level of \$198.7 million. In the out years of the Forecast, growth is expected to range from a low of 4.2% to a high of 5.7% annually. These projected growth rates are far below those experienced in recent years and reflect the impact of the slowing housing market. Additional information about each of the Property Tax sub-categories is provided below.

Secured Property Taxes account for approximately 90% of the revenues in this category. In 2007-2008, Secured Property Tax growth will be driven by annual growth in the property tax roll. The 2007-2008 Secured Property Tax levy will be based on real estate activity in calendar year 2006. Performance in 2006, while still relatively strong, started to slow down with a reduction in the number of property transfers and a leveling off of home prices. Secured Property Tax roll growth of 7.5% is projected for 2007-2008 based on preliminary information from the County of Santa Clara. This would bring Secured Property Tax collections to \$181.4 million. It should be noted that final data on the actual tax levy for 2007-2008 is not available as adjustments are made through July 1, 2007. Updated information on the growth in the tax roll should be available for the development of the 2007-2008 Proposed Operating Budget, which will allow for further refinement of the growth estimate in this category.

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REVENUE FORECAST (CONT'D.)

Property Tax (Cont'd.)

Unsecured Property Taxes are the second largest revenue source in this category. Growth in this category is driven primarily by increases in the value of personal property (e.g. equipment and machinery used by business and industry for manufacturing and production). During the last decade, performance in this category has been extremely volatile with annual growth or declines reaching double-digit levels based primarily on the strength of the local business sector. Collections have been going down in recent years as a result of economic conditions in the region. For the first time in several years, slight growth of 2.2% is projected for 2006-2007 and would bring receipts to \$10.7 million. This collection level is also projected for 2007-2008.

SB 813 Property Taxes (supplemental taxes) represent payments for taxes owed on recent housing resales. With the significant drop in the number of housing resales, collections are expected to fall from the extremely high level of \$10.1 million in 2005-2006 to \$6.5 million in 2006-2007. Collections are projected to fall an additional 15% to \$5.5 million in 2007-2008 based on the assumption that the housing market will continue to experience declines through 2007-2008. All other property taxes (Homeowners Property Tax Relief and Agricultural Tax Relief) are assumed to have little or no growth in 2007-2008, consistent with historical trends.

Sales Tax

The Sales Tax category includes General Sales Taxes and Proposition 172 Sales Taxes. Overall, collections are expected to increase 8.1% in 2006-2007 to \$151.8 million and increase an additional 2.9% in 2007-2008 to \$156.1 million.

The forecast for the General Sales Tax revenue estimate assumes collections of \$147.1 million in 2006-2007, an increase of approximately 8.1% over the actual 2005-2006 collection level of \$136.0 million. Almost all of this growth, however, is the result of timing differences in payments and is not related to actual sales tax performance expected in 2006-2007. Over 60% of the growth expected in 2006-2007 is due to a significantly higher State "triple flip"¹ payment when compared to 2005-2006 as a result of timing

¹ In March 2005, voters approved Proposition 57, the California Economic Recovery Bond Act, which allowed the State to purchase bonds to reduce the State budget deficit. One aspect of the bond measure, referred to as the "triple flip", is a complex set of transactions that involve suspending one-quarter of the Sales and Use Tax and replacing the lost revenues with property tax revenues. This change will remain in effect until the State's bond obligations have been satisfied. As a result, the City has been receiving reduced (down 25%) Sales Tax receipts each month. Under the provisions of the State Budget action, the reduced amounts are offset by payments made twice a year, from property tax receipts (usually in January and May). The City will, however, continue to record the replacement property tax revenues as Sales Tax receipts as this action is considered a temporary situation.

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REVENUE FORECAST (CONT'D.)

Sales Tax (Cont'd.)

differences in the payment schedule. In addition, approximately one-quarter of the growth from the prior year is related to additional revenue from 2005-2006 that had been under-accrued at the end of last fiscal year. When analyzing expected Sales receipts, collections are expected to end the year at approximately the same level as 2005-2006. In December, the City received data on Sales Tax performance for the first quarter of 2006-2007 that reflected a decline of approximately 9%. This decrease, however, was the result of a large one-time downward correction that the City had been anticipating. Excluding that correction, collections were actually flat for the first quarter. For the remaining three quarters, growth of 4% is projected for the second quarter and 2% for both the third and fourth quarters. The rate of growth is lower in the last two quarters because these quarters are being compared to extremely high collection levels in the previous year.

For 2007-2008, General Sales Tax receipts are expected to reach \$151.3 million, an increase of 2.8% over the 2006-2007 estimated collection level. The increase in 2007-2008 reflects an underlying growth rate of 4% for each quarter, plus the estimated payment from the State for the “triple flip”. The 4% growth rate assumes moderate consumer spending that may be somewhat impacted by the softening housing market.

Proposition 172 Sales Tax collections (representing the one-half cent tax that is allocated to counties and cities on an ongoing basis for the use in funding public safety programs) are expected to total \$4.7 million in 2006-2007, which represents growth of 8.2% from the actual 2005-2006 collections. In 2007-2008, growth of 4% is projected and results in a projected collection level of \$4.8 million.

Through the remaining years of the forecast in the Sales Tax category, the growth rate ranges from a low of 3.7% in 2008-2009 to a high of 4.3% in 2010-2011.

Departmental Charges and Other Licenses

The Departmental Charges and Other Licenses categories contain fees and charges imposed by various departments within the City. The most significant revenue sources are from the collection of construction and development-related fees. Revenue collection levels are projected based on City Council-approved cost-recovery policies with the goal of a net-zero impact on the General Fund. When developing the forecast estimates for these categories, the revenues are set at the anticipated collection levels. For 2007-2008, it is assumed that development-related revenues will experience no growth from the estimated 2006-2007 levels. In cases where the development-related revenues are projected to exceed costs, the impacted departments will need to develop budget proposals for incorporation into the 2007-2008 Proposed Operating Budget to increase resources to meet the service demands or to reduce fees. On the other hand, if the projected revenues are not sufficient to cover the base costs, departments will be

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REVENUE FORECAST (CONT'D.)

Departmental Charges and Other Licenses (Cont'd.)

submitting proposals to reduce costs and/or increase fees to bring projected revenues and expenditures back in line for a net-zero General Fund impact. For the non-development-related fees and charges, the 2007-2008 estimates are based on current collection trends. In the out years of the forecast, both the Departmental Charges and Other Licenses categories are expected to experience growth of 4% annually.

Business License Tax

This category includes General Business License Tax and Disposal Facility Tax. In 2006-2007, General Business License Tax proceeds are expected to reach \$13.0 million, an increase of \$1.0 million from the 2005-2006 collection level. The projected increase in receipts is attributed to the Business Tax Amnesty Program that was conducted at the beginning of 2006-2007. In 2007-2008, collections are projected to fall to \$12.3 million, based on the assumption that there will be no Amnesty Program and there will be some ongoing increases associated with the Amnesty Program that was conducted this year.

In the Disposal Facility Tax category, revenue collections in 2006-2007 are expected to meet the budgeted estimate of \$14.7 million and increase by 2% in 2007-2008 to \$15.0 million. In the remaining years of the forecast, the Business License Taxes category is expected to experience very minimal growth of less than 1% per year.

Money and Property

This category consists primarily of interest income. The 2007-2008 estimate for interest earnings on the General Fund and several other funds' cash assume an average interest rate of 4.4%, applied to an average cash balance of approximately \$210.0 million for a total collection level of \$9.2 million. This forecast reflects an increase to the average interest rate yield (up from 3.5%) and an increase in the average cash balance (up from \$190 million), from the assumptions used to develop the 2006-2007 Adopted Budget estimate. Interest transfers from capital and special funds have been adjusted to reflect the various impacts of expected activity and fund balance levels in 2007-2008. These remaining sources in this category are expected to generate \$4.7 million in 2007-2008. In the out years of the forecast, increases ranging from 0.9% to 1.4% are projected.

Motor Vehicle In-Lieu

In 2006-2007 Motor Vehicle In-Lieu collections are expected to reach \$6.3 million based on current collection trends and adjustments for prior year payments. In 2007-2008, slight growth of 1.4% is projected, bringing projected revenues to \$6.4 million. In the out years of the forecast, small annual increases ranging from 2.6% to 2.9% are anticipated.

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REVENUE FORECAST (CONT'D.)

Federal Revenue/Other State Revenue

These categories consist primarily of grant revenues. In the Federal Revenue category, no grants are currently projected to be ongoing into 2007-2008. In prior forecasts, the Federal Revenue category had included the San José LEARNS grants, which will now be administered by the school districts. For State grants, Public Library Foundation funding is projected at \$550,000 and the Senior Companion Program grants are projected at \$130,000 for both 2006-2007 and 2007-2008. The Abandoned Vehicles Abatement Program funding from the State is estimated to be \$710,000 in 2007-2008, which is slightly above the current year estimate. Other ongoing revenues are projected to be received approximately at the current year level for 2007-2008 and are estimated to be relatively flat over the remaining years of the forecast.

Gas Tax

The Gas Tax estimate assumes that collections in 2007-2008 will total \$17.2 million. This collection level is in line with historical tracking patterns for this category. In the out years of the forecast, the expected changes range from a decline of 1.5% in 2011-2012 to an increase of 0.8% in 2008-2009.

Transient Occupancy Tax

It is currently estimated that Transient Occupancy Tax receipts for 2006-2007 will total \$8.4 million, reflecting growth of 9.3% from the 2005-2006 collection level. In 2007-2008, growth of 7% from the 2006-2007 estimate is anticipated based on continued strength in this area. In the remaining years of the forecast, annual growth ranging from 4.4% to 6.3% is projected.

Utility Tax

Utility Taxes are imposed on electricity, gas, water, and telephone usage. Collections in 2006-2007 are anticipated to end the year at \$78.1 million, representing an increase of 3.5% from the 2005-2006 collection level. In 2007-2008, an overall increase of 1.7% is anticipated and would bring collections to \$79.4 million. This growth rate reflects slight increases in the electricity, telephone, and water categories and no growth in the gas utility category. In the Electricity Utility Tax category, an increase of 2% in 2007-2008 is projected based on the assumption that rate increases will be minimal and consumption will experience slight growth. Growth of approximately 5% is anticipated in the Water Utility Tax category based on projected rate increases. Slight growth of 1% in the Telephone Utility category is projected based on projected increases in the cellular phone area. At this point, no growth is projected in the Gas Utility Tax category. The Gas Utility collections have varied significantly in recent years as a result of rate changes associated with the price of natural gas as well as weather-related consumption changes.

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REVENUE FORECAST (CONT'D.)

Utility Tax (Cont'd.)

In the out years of the forecast, growth ranging from 1.4% and 2.6% annually is expected in the Utility Tax category.

Franchise Fees

Franchise Fees are collected in the Electricity, Gas, Cable, Tow, Commercial Solid Waste, Water, and Nitrogen Gas Pipeline categories. Overall, collections are projected at \$37.9 million for both 2006-2007 and 2007-2008. Collections are expected to increase 3.1% in 2006-2007 and remain flat for 2007-2008. The growth in 2006-2007 reflects modest increases of 2% to 3% in the Electricity, City Generated Tow, and Water Franchise Fee categories, larger growth of 4.6% in the Gas category and 10.4% in the Cable category, and no growth in the Commercial Solid Waste and Nitrogen Gas Pipeline categories. In 2007-2008, growth of 2% is projected in the Electricity Franchise category, offset by a projected decline of 4.8% in the Gas Franchise Fee category to bring this volatile category to more historical collection levels. The remaining categories are expected to remain at the 2006-2007 estimated level for 2007-2008.

In the out years of the forecast, Franchise Fee revenues are anticipated to increase from 1.7% to 2.8% annually.

Fines, Forfeitures and Penalties

In 2006-2007, the Fines, Forfeitures and Penalties category is expected to generate \$13.4 million. It is assumed that collections in 2007-2008 will increase by 1.3% to \$13.6 million. This increase is associated with Business Tax Penalties that were lower in 2006-2007 as a result of the Business Tax Amnesty Program and are expected to increase in 2007-2008 to more historical collection levels. In the out years of the forecast, growth ranging from 1.3% to 2.2% is projected annually.

As with the prior forecasts, the long delayed collection of the Garden City penalty payment (\$1.6 million) is not included in this forecast. As this document went to print, a proposed sale of the Garden City Club has been announced. If a sale of Garden City is actually completed and an agreement is finalized on the payoff of the outstanding fine, this revenue would then be able to be programmed as part of the 2007-2008 Proposed Budget process, based on final repayment schedule.

Revenue from Local Agencies

In 2007-2008, revenue of \$46.8 million is projected from other local agencies, such as the Redevelopment Agency, the Central Fire District, and the County. The largest portion of the Revenue from Local Agencies category consists of reimbursements from the San José

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REVENUE FORECAST (CONT'D.)

Revenue from Local Agencies (Cont'd.)

Redevelopment Agency (SJRA). The SJRA reimburses the General Fund for the Convention Center lease payment that is projected at \$14.0 million for 2007-2008. Estimated SJRA reimbursements for City service costs for 2007-2008 of \$15.3 million are based on the assumption that ongoing support will remain consistent with current levels. SJRA reimbursements for past capital expenditures (which enable the City to fund the San José Best Program - \$3.0 million) have also been included in the forecast.

For 2006-2007, Central Fire District payments are expected to end the year at \$6.2 million. Property taxes fund the Central Fire District activities, and those payments for the County areas covered by the San José Fire Department are passed on to the City. Growth of 5.0% is projected for 2007-2008, which factors in a potential impact from annexations. Enterprise Fund In-Lieu payments, representing revenue from the Water Pollution Control Plant and Municipal Water System in lieu of taxes, are expected to increase by a 3.0% in 2007-2008 to \$4.3 million.

Also in 2007-2008, payments from the County of Santa Clara for the first responder advanced life support program (Paramedic Program) are assumed at \$1.7 million as the receipts are based on the annual adjustments approved by the contract with the County.

In 2007-2008, overall growth of 3.1% from the 2006-2007 Adopted Budget is expected in the Revenue from Local Agencies category. In the remaining years of the forecast, annual growth of 2.4% is projected.

Other Revenue

The Other Revenue category consists of miscellaneous revenues received from a variety of sources, including proceeds from the Sale of Surplus Property, cost reimbursements for the Investment Program, Arena Rental, Suite, Parking, and Naming revenues, and reimbursements from the Airport to cover the FMC property debt service payments. Revenue estimates assume continuation of current year activity levels with revisions, where appropriate, for 2007-2008 costs or agreements. Proceeds from the Sale of Surplus Property category has been set at \$100,000 to assume that, at a minimum, the costs of the Real Estate Division related to the sales process will be recovered.

The 2007-2008 estimate for Other Revenue is \$15.7 million. In the remaining years of the forecast, minimal changes ranging from a decline of 1.8% to an increase of 1.3% annually is projected.

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REVENUE FORECAST (CONT'D.)

Overhead Reimbursements

The Overhead Reimbursements category includes overhead reimbursements from both operating and capital funds. In 2007-2008, a total of \$31.0 million is projected based on preliminary 2007-2008 overhead rates prepared by the Finance Department applied against the projected salaries for those positions for which an overhead rate is applied. It should be noted that the Airport rates have not yet been set for 2007-2008. For planning purposes, it is assumed that the overhead rate for Airport funds will be 15% for 2007-2008. It is anticipated that the final Airport overhead rate will be available for incorporation into the 2007-2008 Proposed Operating Budget. In the remaining years of the forecast, an overall average increase of approximately 4.0% is assumed annually reflecting the anticipated cost of living adjustments.

Transfers

The Transfers category is projected at \$44.1 million for 2007-2008, a drop from the 2006-2007 Adopted Budget estimate of \$49.6 million to reflect the elimination of one-time transfers. Upward adjustments to the Airport Crash Fire Rescue and Airport Police Consolidation reimbursements have been assumed in 2007-2008 and the remaining four years of the forecast to reflect cost of living adjustments. The remaining transfers have been reflected at current year levels, with slight adjustments for costs or payment schedules as necessary. For 2007-2008, the transfer from the Emergency Communication System Support (ECSS) Fee Fund has been set at the 2006-2007 Adopted Budget level of \$20.6 million. It is likely this figure will be adjusted as part of the 2007-2008 Proposed Budget after a thorough analysis of eligible costs and revenues generated from the ECSS Fee.

This category is reduced significantly in 2009-2010 due to the potential sunseting of the ECSS Fee. This would result in a loss of \$20.6 million annually.

Reimbursements for Services

The Reimbursements for Services category reimburses the City for actual costs associated with the Deferred Compensation Program and the Maintenance Assessment District Funds. These amounts have been set to recover costs in 2007-2008 of \$625,000, with average increases of approximately 4% in the out years of the forecast to reflect anticipated cost of living adjustments.

Beginning Fund Balance

The forecast estimate for available Beginning Fund Balance in 2007-2008 of \$51.0 million is based on the following assumptions:

- A Contingency Reserve balance of at least \$26.0 million will remain uncommitted by year-end; and

ELEMENTS OF THE GENERAL FUND FORECAST

REVENUE FORECAST (CONT'D.)

Beginning Fund Balance (Cont'd.)

- A total of \$25.0 million will be achieved from a combination of excess revenue, expenditure savings, and the liquidation of prior-year carryover encumbrances. This reflects a base level of excess revenue and expenditure savings that is expected to be available each year of \$20.0 million plus \$5.0 million that is considered available on a one-time basis in 2007-2008 from higher than anticipated collections projected in 2006-2007.

The future year beginning fund balance estimates assume \$20.0 million for the unrestricted portion of the balance. This reflects an increase from \$18.0 million included in the February 2006 Forecast. The carried over Contingency Reserve portion is adjusted upward based on the Contingency Reserve allocation from the prior year.

One-Time Funding Available

Not included in the forecast but available for Council consideration is the **2007-2008 Future Deficit Reserve** of \$10.6 million that was established, per City Council policy, as part of the 2005-2006 Annual Report (\$6.4 million) actions and increased as part of the 2006-2007 Mid-Year Budget Review (\$4.2 million). This reserve was set aside to fund a portion of the shortfall that was projected for 2007-2008 in the February 2006 Forecast. This reserve is not assumed in the remaining forecast years. However, the amount of funding that has been set aside historically for future year deficits has ranged from a low of \$4.3 million in 2000-2001 to a high of \$18.4 million in 2005-2006. Per City Council policy, any remaining unallocated funds available at the close of each fiscal year are directed to be used to cover any projected shortfall in the following year based on the Five-Year General Fund Forecast.

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST

Personal Services

As is our usual practice, the first year (2007-2008) projection for personal services costs in this forecast has been calculated at a detailed level. An extract of payroll system information as of September 2006 was used as the starting point. This individual position-level information was then reviewed, corrected, and updated by each department to include current vacancies and filled positions, accurate salary step status, as well as any position reclassifications. In addition, 2006-2007 ongoing position reductions and additions were annualized, and projections for all categories of benefit costs in the coming year were made.

Personal services costs account for approximately two-thirds of the General Fund's total base costs. In this forecast, for the first time, the Personal Services category has been broken down into its three major components (Salaries and Other Compensation, Retirement, and Health and Other Fringe Benefits). This more refined display of personal services costs is intended to show how these different elements drive rising personnel costs. For example, even without any salary changes, the other major personnel cost components (retirement and health and other fringe benefits) impact personal services and, particularly in recent years, have been responsible for a large part of the major increases in personnel costs. To provide historical context to the growth in this area, from 2000-2001 to 2006-2007, total average personal services costs grew by 45%, with average salary and other compensation increasing 33% over this period, while retirement costs increased 96% and health and other fringe benefit costs grew by 99%.

For 2007-2008, the total personal services preliminary estimate, as displayed in Section Two of this report, represents growth of approximately 7.7% from the 2006-2007 Adopted Budget level. The growth of approximately \$43.6 million results primarily from:

- the presumed favorable outcome for the City of the in progress interest arbitration proceedings with the International Association of Firefighters (IAFF) (the final results of these proceedings are expected to be received in May, 2007);
- the annualization of salary compensation and benefit growth from negotiated bargaining agreements in the current year (2006-2007);
- new negotiated salary compensation and benefit increases with seven of the thirteen bargaining/employee groups, including Unrepresented Non-Management (Unit 8), International Brotherhood of Electrical Workers (IBEW), Association of Engineers and Architects (AEA) (two groups), Association of Building, Mechanical and Electrical Inspectors (ABMEI), Association of Maintenance Supervisory Personnel (AMSP), and Executive Management (Unit 99);
- salary step increases for current employees (an overall 1.3% salary and benefit growth level for the category);
- forecasted health rate increases of 12%;
- actuarially determined Police and Fire Retirement Plan rate increases of 1.5%; and
- the new inclusion of Customer Call Center staffing costs in this category as the Information Technology Department has now assumed responsibility for the management of this function. As a result, the Customer Call Center is now included in the Personal Services and Non-Personal/Equipment categories, which is offset by a reduction in the City-Wide Expenses category where these costs were previously displayed.

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Personal Services (Cont'd.)

It is important to note that not included in the Personal Services category are Workers' Compensation Claims Payments and Sick Leave Payments Upon Retirement. These costs, which are included in the City-Wide Expenses category, are also considered key expenditure components of the cost of the City's workforce. In 2007-2008, \$17.4 million for Workers' Compensation Claims Payments and \$8.2 million for Sick Leave Payments Upon Retirement have been included in this forecast.

It should also be noted that due to the mechanism used to represent the desired outcome in fee programs, personal services expenditures in this forecast are further understated by approximately \$4.1 million. The \$4.1 million represents the shortfall that would exist in the development-related fee programs in the Fire, Planning, Building and Code Enforcement, and Public Works Departments if all costs were reflected. These fee programs are intended by the City Council to recover 100% of the cost of development review and inspection and, as a result, costs are reflected in this forecast at the expected revenue collection level. Each of the fee programs will be required to develop strategies that will address this \$4.1 million shortfall in the 2007-2008 Proposed Operating Budget process.

As with past forecasts, personal services costs in years two through five of the forecast have been projected on a more global basis, using the detailed costs calculated for the first year as a base, and then growing that base by an overall percentage factor representing expected growth from salary and benefit adjustments. For this forecast, the out years were projected to inflate at a composite rate of approximately 4.7%, which is approximately consistent with the projected rate of growth presumed in the February 2006 Forecast.

Non-Personal/Equipment

Non-personal/equipment expenditures for the first year of the forecast have also been calculated at a detailed level. The process utilized by the Budget Office includes adjusting each department's current year budget to eliminate one-time allocations, annualizing all partial-year reductions or additions approved for 2006-2007, and including projected adjustments for specific large non-personal/equipment allocations (e.g., utilities, leases, contracted services and Police Department vehicle replacement) as described later in greater detail. The resulting 2007-2008 estimates represent a slight decrease (\$137,000) from the current year level. This reflects the net impact of deleting one-time additions and rebudgeted items and annualization of actions included in the 2006-2007 Adopted Budget. In addition, as discussed in the Personal Services section above, funding has been included here for the Customer Call Center that was previously funded in City-Wide Expenses category.

Departmental gas and electricity funding for 2007-2008 has been projected to remain relatively flat in this forecast to reflect approved gas and electricity rates, and projected consumption changes from expanded City facilities at a net increased cost of \$290,000 in the General Fund.

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Non-Personal/Equipment (Cont'd.)

Other specific adjustments included in the 2007-2008 non-personal/equipment base include increases for vehicle maintenance and operating costs (\$308,000) and contractually required cost of living increases to major contracts. In addition, a 1.6% increase, which represents ½ of the San Francisco-Oakland-San José area consumer price index for the past 12 months, has been applied to eligible expenditures. An eligible expenditure in the non-personal/equipment category is non-centrally determined details, such as supplies, postage, and printing, and expenditures that have not already been inflated for negotiated contracts and agreements. For the out years of the forecast, a growth rate of 2.0% has been assumed from the 2007-2008 non-personal/equipment base level in each of the four years. This projection is unchanged from that assumed in recent forecasts.

Other Expenditures

The General Fund **Capital Projects** category includes \$785,000 for the Congestion Management program and debt service payments for Central Service Yard – Phase I (\$796,000 in 2007-2008). This is a reduction of \$878,000 from the previous forecast to reflect budget actions taken in 2006-2007 for two years. Also included in this category is the continuation of allocations for Arena repairs, unanticipated maintenance of City facilities, and fuel tanks and methane monitoring control and replacement.

As was the case in previous forecasts, continued capital funding for the Replacement of Fire Apparatus is carried in this forecast. In 2007-2008, the level of funding is \$1.05 million and increases to \$2.4 million in 2011-2012 to fund the current Fire Vehicle Replacement Policy. This is a reduction of \$850,000 from the previous forecast to reflect budget actions taken in 2006-2007 that impacted both 2006-2007 and 2007-2008.

A Sidewalk Repair Program capital allocation of \$683,000 per year is included to provide ongoing funding for the repair of deteriorating sidewalks for owner-occupied residences. In 2005-2006 the amount of funding the City would contribute for sidewalk repairs was capped. The property owners are responsible for those costs above the cap.

The **City-Wide Expenses** program in the first year of the forecast (2007-2008) represents a net reduction of \$35.4 million from the 2006-2007 level. This large reduction reflects the combined impact of deleting rebudgets (\$29.6 million), one-time grants (\$6.8 million) and other one-time items (\$1.8 million) budgeted in 2006-2007. In addition, due to changes by the State, the City should no longer be financially responsible for the County of Santa Clara costs to process prisoners. As a result, \$2.5 million funding for this activity has been removed from the City-Wide Expenses category. During 2006-2007, the Information Technology Department has assumed responsibility for the Customer Call Center. Funding in the amount of \$1.28 million has been reallocated from City-Wide to the Personal Services and Non-Personal/Equipment categories. This overall reduction is partially offset, however, by increases of \$325,000 for debt

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Other Expenditures (Cont'd.)

service payments for the Convention Center (\$14.0 million in 2007-2008); the annualization of debt service payments for the FMC property, a portion of which are offset by additional Airport reimbursements (\$2.7 million increase); and the inclusion of maintenance costs (\$300,000) for the recently acquired FMC property. In addition, just last week the County notified the City of a significant increase of \$1.55 million (from \$1.1 million to \$2.6 million) in the City's share of the cost of the County's property tax administration costs. This represents an approximate 140% increase over the City's most recent payment in 2005-2006. Administration will be working with the County's Finance Department to understand the methodology used to arrive at this huge increase. Workers' Compensation Claims payments in this forecast range from \$17.4 million in 2007-2008 to \$21.3 million in 2011-2012. Sick Leave Payments Upon Retirement expenditures have been included in this forecast at \$8.2 million for 2007-2008.

The **Earmarked Reserves** category includes a reserve for the Comprehensive General Plan Update (\$200,000). Funding for this activity is being built over a four year period and now totals \$800,000. This reserve is entirely offset by revenues collected from a surcharge on development permits. Not included here are any Earmarked Reserves that may remain unspent in 2006-2007, and rebudgeted to 2007-2008. Some of the larger current Earmarked Reserves include the Development Fee Program Reserves, Workers' Compensation/General Liability Catastrophic Reserve, Enhanced Parks Maintenance Reserve, Salary and Benefits Reserve, Hayes Mansion Conference Center Line of Credit Reserve, Future Capital Projects (FF&E) Reserve, Neighborhood Investment Fund Reserve, and Economic Uncertainty Reserve.

As in previous years, the **Equipment** category includes a general equipment reserve of \$100,000 for subsequent allocation in the 2007-2008 Proposed Budget. Similarly, \$250,000 is assumed annually for computer equipment and automation projects also for subsequent allocation during the Proposed Budget process.

The **Transfers** category includes funding for Communications Center debt service as required under the terms of financing used for construction of this facility (\$2.4 million in 2007-2008), and funding to cover a portion of the debt service payments for the Hayes Mansion Conference Center (\$4.4 million per year) and Rancho del Pueblo and Los Lagos Golf Courses (\$1.25 million per year). All of the debt service and maintenance and operations costs for these facilities are funded in the Community Facilities Revenue and Municipal Golf Course Funds, however, revenues in those funds are not projected to be sufficient to completely cover these costs. In addition, revenue-offset payments for the Camden Lifetime Activities Center debt service (\$215,000 in 2007-2008), Fiber Optics loan repayment and various Maintenance Assessment Districts for the General Fund's share of landscape services in those areas are included.

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Other Expenditures (Cont'd.)

A **Vehicle Replacement/General Fleet** allocation of \$1.75 million per year is included to fund a vehicle replacement schedule for the General Fleet.

In 2007-2008, **Vehicle Replacement/Police Fleet** funding is carried in the departmental budget (\$3.5 million). Due to the large variation in funding levels necessary to fund the replacement of Police vehicles over the five-year period, the incremental costs necessary to ensure that replacement schedules for the marked covert and unmarked Police fleet are met are shown as a separate line item. In this forecast, they range from an increased need of \$2.0 million in 2009-2010 to a reduced need of \$1.8 million in 2008-2009.

Contingency Reserve

Per City Council policy, the 2007-2008 Contingency Reserve is projected at the level necessary to comply with the City Council policy to maintain a 3% Contingency Reserve (\$27.3 million). Amounts necessary to remain in compliance with that policy are also included in each of the remaining four years of the forecast.

Committed Additions to the Base General Fund Forecast

In this forecast, projected additions to the base expenditure level have been included as **Committed Additions**. The **Committed Additions** are additional expenditures to which the City is considered to be committed by prior City Council action, such as the costs related to maintaining and operating capital projects previously approved by City Council. Typically, the forecast Base Case, considered most closely by the City Council, includes ongoing program costs plus committed additions.

The following committed additions are included in the 2008-2012 forecast and explained in more detail in a later section of this document:

Increased costs for street lighting and maintenance of scheduled **Street Improvements** (\$338,000 in 2007-2008) are shown as a Committed Addition.

New Parks and Recreation Facilities Maintenance and Operations costs (\$417,000 in 2007-2008) are included at the levels necessary to support the additional costs of maintaining and operating new park facilities that were included in the City's latest Five-Year Capital Improvement Program and those that are being developed by other agencies.

A new item for completion of a **Comprehensive General Plan Update** (\$820,000 in 2007-2008) has been included in three of the five years. Traditionally, General Plans undergo a comprehensive update every ten years. San José's last comprehensive update was completed in 1994. The completion of this Update would ensure that the City would not lose its authority to regulate land use and issue permits that could not be challenged under state law.

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Committed Additions to the Base General Fund Forecast (Cont'd.)

The Mayor's June Budget Message for Fiscal Year 2006-2007 directed that a Comprehensive General Plan Update begin in January 2007. This is a new funding requirement that was not included in the February 2006 Forecast.

The approved bond measures from the elections of November 2000 and March 2002 will result in new and expanded library (**Measure O**), park (**Measure P**), and police and fire facilities (**Measure O**) and will require additional **Maintenance and Operations** funding (\$577,000 in 2007-2008).

ELEMENTS OF THE GENERAL FUND FORECAST

OPERATING MARGIN

Base Case expenditures, including committed additions, increase from \$847.0 million in 2007-2008 to \$1.01 billion in 2011-2012, for an average growth rate of approximately 4.5%. General Fund sources (including Beginning Fund Balance), on the other hand, total \$830.8 million in 2007-2008, and grow to \$923.2 million in 2011-2012, an average growth rate of only 2.7%.

Compared to the February 2006 Forecast, expected growth rates in the out years of the forecast for expenditures have changed, increasing from 4.3% to 4.6% for the comparable period of 2008-2009 through 2010-2011. Expectations for overall growth rates for revenue collections during the comparable three-year period have on the other hand decreased from 3.4% to 2.4%. This decline, however, was largely due to the sunseting of the Emergency Communication System Support Fee in 2009-2010 in the latest forecast model.

As discussed above, the Base Case with Committed Additions Forecast for the General Fund projects a shortfall in the first year (2007-2008) of \$16.2 million. This is lower than both the November 2006 Preliminary Forecast shortfall estimate of \$19.8 million, and the February 2006 Forecast shortfall of \$39.0 million for 2007-2008.

The following table shows how the projected shortfall has changed in the most recent forecasts. The incremental shortfall (assuming each preceding deficit is solved completely with ongoing solutions in the year it appears) for each of the four out years of the forecast is shown below, along with a comparison with the increments projected for those years in the February 2006 Forecast and the preliminary 2007-2008 update provided to the City Council in November 2006.

ELEMENTS OF THE GENERAL FUND FORECAST

OPERATING MARGIN

Base Case with Committed Additions Changes in Operating Margin 2008-2012 (\$ in Millions)					
	<u>2007-2008</u>	<u>2008-2009</u>	<u>2009-2010</u>	<u>2010-2011</u>	<u>2011-2012</u>
February 2006	(\$39.02)	(\$11.44)	(\$15.24)	(\$4.93)	N/A
Incremental Surplus/(Shortfall)					
2006-2007					
Adopted Budget					
Impact	(\$2.71)				
Incremental Surplus/(Shortfall)					
Revised Forecast	(\$41.73)	(\$11.44)	(\$15.24)	(\$4.93)	N/A
November 2006					
Incremental	(\$19.85)	(\$27.25)	(\$38.56)	(\$12.51)	(\$9.51)
Surplus/(Shortfall)					
February 2007					
Incremental	(\$16.20)	(\$25.54)	(\$34.28)	(\$3.60)	(\$7.81)
Surplus/(Shortfall)					
One-time					
Funding	\$10.63	N/A	N/A	N/A	N/A
Available					

In the February 2006 Forecast, an incremental shortfall of \$39.02 million for 2007-2008 was projected. This figure was based on the assumption that the entire 2006-2007 shortfall would be solved with ongoing actions. However, the 2006-2007 Adopted Budget included a combination of ongoing and one-time solutions. The carryover impact of those one-time measures is reflected in the 2006-2007 Adopted Budget Impact incremental shortfall of \$2.7 million and, when combined with the previous shortfall anticipated for 2007-2008, would result in a deficit of approximately \$41.73 million in 2007-2008.

In November 2006, staff prepared a Preliminary Five-Year General Fund Forecast incorporating the final 2005-2006 actual performance and the first few months of activity in 2006-2007. In this preliminary forecast, the General Fund deficit for 2007-2008 was

ELEMENTS OF THE GENERAL FUND FORECAST

OPERATING MARGIN (CONT'D.)

reduced from \$41.73 million to \$19.85 million, primarily as a result of higher than anticipated revenues. The additional revenue was spread among several categories with the largest impacts in the Sales Tax, Property Tax, Money and Property, Overhead, Cardroom, and 2007-2008 Beginning Fund Balance categories.

For the February 2007 Forecast, staff completed an in-depth review of anticipated revenues and expenditures for 2007-2008 and the remaining four years of the forecast period. Based on this updated information, a 2007-2008 General Fund shortfall of \$16.2 million is projected, a net decrease of \$3.7 million from the November 2006 figure. The slight reduction reflects net downward expenditure adjustments of \$5.2 million, partially offset by a net revenue reduction of \$1.5 million.

In the out years of the Base Case Forecast, incremental shortfalls ranging from \$3.6 million to \$34.3 million annually are projected. The persistent shortfalls reflect the fact that revenue growth is projected to lag behind the growth in expenditures in all five years. The large spike in the shortfall (\$34.3 million) in 2009-2010 is based on the presumption of a sunseting of the Emergency Communication System Support Fee, with a resulting loss of \$20.6 million in revenue that year. In the final year of the Forecast, the incremental shortfall of \$7.8 million reflects less than 1% of the projected expenditures in that year of \$1 billion.